

Chapter 11

A Guide to the Self-Correction and Audit Closing Agreement Programs

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**INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES**

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Overview of chapter

Purpose of the chapter

The purpose of this chapter is to provide Employee Plans Specialists with the necessary tools to perfect a case under the Self-Correction or Audit Closing Agreement Program. The chapter discusses:

- Sample closing agreement language,
 - Sample correction methods,
 - Sample negotiation techniques, and
 - Updates previous CPE material for changes to Rev. Proc. (Rev. Proc.) 2002-47 and general policy concerns.
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Historical perspective on EPCRS

Brief history of the programs under EPCRS

The Audit Closing Agreement Program (Audit CAP) was established as a pilot program in 1990. Audit CAP was restrictive as to the issues that could be resolved, specifically excluded certain issues, and required correction of the issues and the payment by the employer of a sanction equal to a negotiated percentage of the “maximum payment amount” (an amount that approximates the tax owed if the plan were disqualified). Audit CAP was made permanent in 1991.

In 1991, Administrative Policy Regarding Sanctions (APRS) was put into place to resolve insignificant operational issues found in plans on examination. This program required correction of the issues and permitted the plan to retain its qualified status without imposing any monetary sanctions on the employer. APRS contained very stringent, narrow eligibility requirements.

In 1992, the Voluntary Compliance Resolution (VCR) was established as an experimental program administered in Washington, DC. VCR was made permanent in 1994. Employers who had favorable determination letters were able to disclose operational violations to the Service, make the required corrections, and pay a fixed fee to the Internal Revenue Service based on the size of the plan.

In 1994, the Service established the Walk-In Closing Agreement Program (Walk-In CAP) to provide a correction program for cases not eligible for VCR. This program did not require an employer to have a favorable determination letter and provided relief for plans with Plan Document Failures and Demographic Failures. Like Audit CAP, the sanction was negotiated based on the facts and circumstances. This program was administered in the field offices.

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Historical perspective on EPCRS, Continued

**Brief history
of the
programs
under EPCRS
(continued)**

The Tax-Sheltered Annuity Correction Program (TVC) was established for sponsors of 403(b) Plans in 1995. This program provided sponsors of these plans an opportunity to resolve Operational Failures, and like Walk-in CAP and Audit CAP, the sanction was negotiated based on the facts and circumstances. This program was initially administered in Washington, DC and moved to the field in 1999.

The Administrative Policy Regarding Self-Correction (APRSC) was established in 1996 to replace APRS. APRSC significantly expanded the original criteria for eligibility and extended relief to 403(b) Plans.

Rev. Proc. 98-22 modified APRSC, VCR, Walk-in CAP, and Audit CAP and consolidated them into one comprehensive system of correction programs for sponsors of retirement plans called the Employee Plans Compliance Resolution System (EPCRS). TVC was added to EPCRS in 1999.

Rev. Proc. 99-31 set forth sample correction methods that could be used by employers when correcting their plans.

Rev. Proc. 2000-16 consolidated the procedures for all of the EPCRS programs into one document and also incorporated the correction methods of Rev. Proc. 99-31 (designated as a new Appendix B).

Rev. Proc. 2001-17 modified and superseded Rev. Proc. 2000-16 by combining VCR and Walk-in CAP into one program called the Voluntary Correction Program (VCP). It renamed APRSC the Self-Correction Program (SCP), permitted group and anonymous submissions under VCP, included procedures for SEPs, and permitted correction by use of retroactive plan amendments for certain defined failures without Service approval.

The current guidance for these programs is found in Rev. Proc. 2002-47, which modified and superceded Rev. Proc. 2001-17. The section of EPCRS that relates to the Voluntary Compliance Program is beyond the scope of this chapter.

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Historical perspective on EPCRS, Continued

Advantages of EPCRS

A plan can be disqualified for any form of Operational Failure, and the Service can assess the adverse tax consequences that flow from disqualification to the Plan Sponsor, the plan participants, and the trust. See also the court rulings in *Buzzetta Construction Company v. Commissioner*, 92 T. C. 641 (1989) and *Martin Fireproofing v. Commissioner*, 92 T. C. 1173 (1989), where the Tax Court affirmed the Service's discretion to retroactively disqualify plans notwithstanding inadvertence, relatively minor failures, and otherwise competent plan administration.

Under EPCRS, the Plan Sponsor may correct violations and avoid the results of plan disqualification and revocation of a previously issued determination letter.

The goals of EPCRS are based on the following principles:

- Plan Sponsors should be encouraged to establish administrative practices and procedures.
 - Plans should satisfy the applicable plan document requirements of the Internal Revenue Code.
 - Plan Sponsors should make voluntary and timely correction of plan failures.
 - Sanctions should be reasonable in light of the nature, extent, and severity of the violation.
 - Administration of EPCRS should be consistent and uniform.
 - Plan sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.
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Self-Correction Program

Introduction

Part IV of Rev. Proc. 2002-47 provides guidance with regard to the Self-Correction Program (SCP). Section 8 describes the requirements that apply to insignificant Operational Failures while section 9 describes the requirements that apply to significant Operational Failures.

Significant vs. Insignificant Operational Failures

SCP can be used by a Plan Sponsor who has established compliance practices and procedures without paying any fee or sanction to correct the following:

- Insignificant Operational Failures can be corrected at any time.
- Significant Operational Failures can only be corrected within the SCP correction period specified in section 9.02 of Rev. Proc. 2002-47, and the plan must have a Favorable Letter.
- Correction by plan amendment in the following situations if the specific correction methods prescribed for such failures in section 2.07 of Appendix B to Rev. Proc. 2002-47 are followed:
 1. Internal Revenue Code (Code) section 401(a)(17) failures.
 2. Hardship distribution failures.
 3. Inclusion of ineligible employee failures.

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Self-Correction Program, Continued

Multiple failures and factors for determining insignificance

The following list includes factors that may be used to determine whether an Operational Failure is insignificant:

1. Determine whether other failures occurred during the period being examined.
2. Determine the percentage of plan assets and contributions involved in the failure.
3. Determine the number of years the failure has occurred.
4. Determine the number of participants who could have been affected as a result of the failure.
5. Determine the number of participants affected relative to the total participants.
6. Determine whether correction was made within a reasonable time after discovery of the failure.
7. Determine the reason for the failure;

Remember that no one factor is determinative, and these factors are not meant to exclude small plans.

Multiple failures-in the case of a plan with:

- More than one operational failure in a single year, or
- Operational failures that occur in more than one year,

The sponsor is eligible for self-correction under the insignificant policy, **only if** the Operational Failures in the aggregate are insignificant.

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Self-Correction Program, Continued

Defining the correction period for significant Operational Failures

The end of the correction period for self-correction of significant Operational Failures is generally the last day of the second plan year following the plan year for which the failure occurred.

In the case of a failure to satisfy the requirements of Code section 401(k)(3) or 401(m)(9), the correction period does not end until the last day of the additional period for correction permitted under Code section 401(k)(8) or 401(m)(6).

If a 403(b) Plan does not have a plan year, the plan year is deemed to be a calendar year for this requirement.

There are special rules and an extended correction period for Transferred Assets, as defined in section 5.01(8) of Rev. Proc. 2002-47, from a corporate merger, acquisition, or similar transaction

Effect of an examination: Generally, the correction period ends on the first date the plan or Plan Sponsor is under examination for that plan year. (Refer to section 5.03 of Rev. Proc. 2002-47 for the specific definition of “Under Examination.”) However, if correction has been substantially completed by the time a plan becomes Under Examination, the plan sponsor is permitted to complete correction after the correction period has expired and be eligible for SCP.

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Self-Correction Program, Continued

When correction is substantially completed

Correction must occur for all affected participants and for all affected plan years. However, the correction of an Operational Failure may be considered as substantially completed if:

1. During the correction period, correction is completed with respect to 85% of all affected participants, and the Plan Sponsor completes correction for the remainder of the affected participants in a diligent manner.
2. During the correction period, the Plan Sponsor is reasonably prompt in identifying the Operational Failure, formulating a correction method, and initiating correction in a manner that demonstrates a commitment to completing correction as expeditiously as practicable, and within 90 days after the last day of the correction period, the Plan Sponsor completes correction of the Operational Failure.

SCP and plan amendment

Section 4.06(2) of Rev. Proc. 2002-47 permits a Plan Sponsor to self-correct an Operational Failure by amending the plan to conform its terms to its prior operations, but only if such Operational Failure is one of three failures described in section 2.07 of Appendix B to Rev. Proc. 2002-47. (Note: Section 2.07 of Appendix B describes specific Operational Failures relating to Code section 401(a)(17) failures, hardship distribution failures, and inclusion of ineligible employee failures. It also explicitly describes the correction methods that the Plan Sponsor must use to correct each of the failures under SCP by plan amendment.) And like any permitted corrective amendment, the plan amendment must comply with the requirements of Code section 401(a), including the requirements of Code sections 401(a)(4), 410(b), and 411(d)(6).

If the Operational Failure is self-corrected via plan amendment as described above, the Plan Sponsor must submit a determination letter application, Form 5300 series or Form 6406, during the correction period to ensure that the amendment satisfies applicable qualification requirements. There is a separate user fee for the determination letter application.

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Self-Correction Program, Continued

**Verifying a
plan's self
correction—
exam steps**

Ask the Plan Sponsor or authorized representative for documentation that substantiates the self-correction of the Operational Failure. When reviewing the provided documentation:

- Verify that any required corrective contributions or corrective distributions were adjusted for earnings (or losses).
- If the Operational Failure was significant, verify that all necessary steps were taken to complete correction within the SCP correction period prescribed by Rev. Proc. 2002-47, section 9.02.
- If the Plan Sponsor used a correction method that was not specifically described in Appendices A or B to Rev. Proc. 2002-47, verify that the correction method complied with the applicable correction principles described in section 6 of Rev. Proc. 2002-47, especially those outlined in section 6.02(2) with regard to reasonable and appropriate correction.
- Document in your workpapers what steps you took to verify self-correction of the Operational Failure(s).
- Recompute the tests that were included in the documentation. (See also the section on workpaper techniques below.)

Illustrations of SCP—plan failed ADP/ACP test

Plan failed ADP/ACP tests and only corrected for ADP prior to audit--Facts

Let's now examine a case that illustrates the proper use of the SCP. During the audit interview, the authorized representative provided the specialist with the nondiscrimination test for a defined contribution profit sharing plan with a 401(k) contribution and matching contribution (the ADP and ACP tests). The plan failed to pass these tests.

Specialist verified corrective distributions were made for the 401(k) portion

The specialist determined that the Plan Sponsor distributed the excess contributions to the highly compensated employees 5 months after the end of the plan year and then issued Forms 1099-R for the corrective distributions.

For corrective distributions of excess contributions, Code section 4979 imposes a tax on the Plan Sponsor equal to 10% of any excess contributions not corrected within 2½ months after the end of the plan year to which they relate.

The specialist determined that the Plan Sponsor timely filed the required Form 5330 for the 4979 excise tax liability. **Note: Form 5330 is required to be filed within 15 months after the end of the plan year to which the excess contributions relate.**

Specialist determined that the correction of the excess aggregate contributions was not made

When the specialist asked for the information to verify correction for the matching portion of the plan, the representative was not able to provide this.

The employer had switched third party administrators after the nondiscrimination test was computed, but before corrections were made for the matching portion of the nondiscrimination test.

No further correction was required of the Plan Sponsor with regard to the ADP test correction, as it was corrected within the statutory correction period. The specialist required the Plan Sponsor to complete correction of the matching portion of the test. The Plan Sponsor made the required distributions of the excess aggregate contributions with the earnings thereon and made QNCs to the plan equal to the same amount.

The Plan Sponsor filed the delinquent Form 5330 for the excise tax due under Code section 4979. The Plan Sponsor issued Forms 1099-R for the corrective distributions for the 401(m) portion of the plan.

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Illustrations of SCP—plan failed ADP/ACP test, Continued

Plan was still eligible for correction under SCP—even though part of the correction was not made until audit

The specialist discussed the case with his/her group manager and the Area Coordinator. Considering the relevant factors, all agreed that this case would be eligible to be closed under SCP. The relevant factors are as follows:

- The Plan Sponsor had identified the Operational Failure and initiated correction prior to the audit.
- The Plan Sponsor and representative cooperated with the specialist during the entire examination process.
- The number and amount of the Operational Failure(s) were not excessive.
- The specialist noted whether the Operational Failure affected only highly compensated employees (HCEs) or nonhighly compensated employees or both. The failure affected 2 HCEs only.
- The only year affected was the year prior to the year under audit. The Operational Failure did not recur in the year under audit or the subsequent year.
- The Plan Sponsor took action, during the audit, to ensure that this type of Operational Failure did not recur. The Plan Sponsor changed practices and procedures to ensure that management reviewed the nondiscrimination test at the fiscal year-end.

Excise tax issue

The excise tax issue was outside of the scope of the Self-Correction Program, but it had to be resolved concurrently with the closing of the examination.

When Area Coordinator does not have to approve correction method and other tips

You may need to discuss the issue(s) with your manager and the Area Coordinator. If the correction method is one that is described in Appendix A or B to Rev. Proc. 2002-47, then the Area Coordinator does not need to approve the method of correction.

If the method is outside of the scope of the examples in Rev. Proc. 2002-47, then you will need to discuss the method with the Area Coordinator.

The correction method must resemble one in the Code or the Regulations.

Review the terms of the plan. Sometimes the plan will describe the correction method. For example, use a suspense account for excess annual additions under Code section 415.

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Illustrations of SCP—plan failed ADP/ACP test, Continued**Illustration of another failure discovered on audit that was corrected under SCP**

A profit sharing plan with a 401(k) feature failed to satisfy the nondiscrimination test under Code section 401(k). The error was discovered during the audit of the plan. The Operational Failure occurred only in the year under audit. There were 20 participants in the plan, three of whom were HCEs. The Excess Contributions equaled \$500.00. The plan had a current favorable determination letter. (See section below on the definition of Favorable Letter for EPCRS purposes.)

The specialist inquired as to how the Operational Failure occurred. The Plan Sponsor told the specialist that they had relied on the professional advice of a third party administrator, who had failed to inform them that action needed to be taken to correct the failed 401(k) test.

The specialist informed the Plan Sponsor that, if it agreed to immediately correct the failure, the plan would be eligible for the SCP. The Plan Sponsor agreed to correct under SCP because the Plan Sponsor would not have to pay any fee or sanction.

The Plan Sponsor subsequently corrected the Operational Failure by using the One-to-One Correction Method described in section 2.01(1)(b) of Appendix B to Rev. Proc. 2002-47, which requires the Plan Sponsor to:

- Distribute the excess contributions to the highly compensated employees, and
- Make Qualified Nonelective Contributions on behalf of the non-highly compensated employees in an amount equaling the total of the corrective distributions, adjusted for earnings.

Audit CAP

**Introduction
and failures
that can be
resolved under
Audit CAP**

If the Service identifies any of the following during an Employee Plans or Exempt Organization audit of a Qualified Plan, 403(b) Plan, or SEP, then the Service may resolve the failure(s) under the Audit Closing Agreement Program (Audit CAP):

- Significant Operational Failures that were not timely corrected under SCP,
- Plan Document Failures, Demographic Failures, or Employer Eligibility Failures that were not corrected under the general procedures of the Voluntary Correction Program (VCP), or
- 403(b) Failure(s) that were not corrected under the Voluntary Correction of Tax-sheltered Annuity Failures.

The Plan Sponsor must:

- Correct the failure(s) by using the correction method prescribed by the Service,
- Pay a sanction, and
- Satisfy additional requirements to improve the plan's administrative practices and procedures to ensure continued compliance with the terms of the plan, the Code, and the Regulations.

**Types of
Qualification
Failures**

A Qualification Failure means any failure that adversely affects the qualification of a plan. The term includes four types of failures:

- A Plan Document Failure,
- An Operational Failure,
- A Demographic Failure, and
- An Employer Eligibility Failure.

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Audit CAP, Continued

Plan Document Failure A Plan Document Failure is a plan provision (or absence of a provision) that violates the requirements of Code section 401(a) or 403(a). A Plan Document Failure also includes a failure to amend the plan for a newly enacted qualification requirement within the remedial amendment period under Code section 401(b). (The latter type of Plan Document Failure is commonly referred to as a “nonamender” failure.)

Common nonamender failures result from changes to Code sections 401(a)(17) and 401(a)(31) by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) and the Unemployment Compensation Amendments Act of 1992 (UCAA '92).

Both examination and determinations agents may discover Plan Document Failures during their review of the initial plan document or plan amendments.

A review of plan terms and adoption dates is usually one of the first steps an examinations specialist will perform during the initial audit appointment. The determinations agent will review the classification notes when opening a new determination case.

Operational Failure An Operational Failure means any Qualification Failure (other than an Employer Eligibility failure) that arises solely from the failure to follow the terms of the plan.

An Operational Failure is a common problem that is resolved under Audit CAP. For example, a Plan Sponsor may fail to follow the terms of the Qualified Plan for eligibility (Code section 410) and leave out eligible participants or may not properly count years of service, according to the plan terms, and improperly vest participants (Code section 411).

For section 403(b) Plans, common Operational Failures are instances where employee deferrals exceed the limitations of Code section 402(g). Also, there have been section 403(b) Plans where the employee deferrals have exceeded the applicable limits under Code section 415.

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Audit CAP, Continued**Operational
Failure**
(continued)

A determination specialist who identifies a partial vesting issue upon a review of Form 5310 (for a terminating plan) may resolve this issue using the sanction structure of Audit CAP. The determination specialist with his/her manager may decide to handle this issue locally or refer this issue to the examination function and a field group. Form 5666 is used for this purpose.

**Demographic
Failure**

A Demographic Failure means a failure to satisfy the requirements of Code sections 401(a)(4), 401(a)(26) or 410(b) that is not an employer eligibility failure or an operational failure. The failure to meet the requirements under Code section 401(a)(26) may occur when a plan is frozen.

**Employer
Eligibility
Failure** (A
**common
problem in
SARSEP
examination
cases)**

An Employer Eligibility Failure means adoption of a plan intended to satisfy the requirements of Code sections 401(a), 403(b), or 408(k) by an employer that fails to meet the employer eligibility requirements to establish a 401(k), 403(b), or 408(k) plan. An Employer Eligibility Failure is not a Plan Document, Operational, or Demographic Failure.

This type of failure commonly occurs in SARSEP examination cases, where the employer has more employees than the limits under Code section 408(k) permit. This type of failure also commonly occurs in 403(b) Plans where, for example, the local government employer is ineligible to sponsor such a plan. Employer Eligibility Failures include a failure to initially establish or maintain a custodial account as required by Code section 403(b)((7). SCP is not available to resolve Employer Eligibility Failures.

The Maximum Payment Amount and Sanction amount

Definitions relating to sanctions

For Qualified Plans, the sanction is a negotiated portion of the Maximum Payment Amount (MPA). The MPA is defined as the monetary amount that is approximately equal to the tax the Service would collect upon plan disqualification, which is:

- The sum of the tax on realized trust earnings for all open years (Form 1041).
- The income tax on the disallowed deductions for the non-vested allocations of employer contributions (Form 1120, 1065 or schedule C Form 1040) and
- The income tax on the vested allocations to participants' accounts under the plan (Forms 1040).

Refer to section 5.01(5) of Rev. Proc. 2002-47 for a more precise definition of MPA.

For SEPs and 403(b) Plans, the sanction is a negotiated portion of the Total Sanction Amount (TSA). Per section 5.02(5) of Rev. Proc. 2002-47, the TSA is defined as the monetary amount that is approximately equal to the income tax the Service could collect as a result of the failure.

Estimating the Maximum Payment Amount

The specialist can ask the Plan Sponsor or the authorized representative to estimate the MPA during the examination or determination process. If all of the information used to estimate this figure is not available, then the specialist may estimate the MPA from the facts in the workpapers, books, and records. If the Plan Sponsor and/or the representative believe the specialist's estimate is inaccurate, it will sometimes prompt them to make a more reasonable computation.

See Chapter 14 of the text for CPE 2002 for a template for estimating the MPA.

Remember, there can only be one plan per closing agreement; therefore, if you discover Qualification Failures in more than one of a Plan Sponsor's plans, you'll need to obtain estimates of the MPA for each of the plans. This makes it possible for the Service Center to document the sanction at the conclusion of the audit.

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The Maximum Payment Amount and Sanction amount,

Continued

**Determining
the sanction
amount —
factors to
consider**

The sanction must bear a reasonable relationship to the nature, extent and severity of the failures. Consider the following factors when determining the sanction amount:

- The steps taken by the Plan Sponsor to ensure that the plan had no failures,
- The steps taken to identify failures that may have occurred,
- The extent to which correction had progressed prior to the audit (including full correction),
- The amount of the fees that the Plan Sponsor would have paid if it had resolved the failure(s) under the Voluntary Compliance Program,
- The number and type of employees affected by the failure,
- The number of nonhighly compensated employees that would have been adversely affected had the plan been disqualified or the SEP or 403(b) Plan failed to meet the requirements of Code sections 403(b) or 408(k), respectively,
- Whether the failure is a failure to satisfy the requirements of Code section 401(a)(4), 401(a)(26), or 410(b), either directly or through section 403(b)(12),
- The period of time over which the failure occurred, and
- The reason for the failure.

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The Maximum Payment Amount and Sanction amount,

Continued

Additional factors specifically for Qualified Plans and 403(b) Plans

There are additional factors to consider for Qualified Plans, such as:

- Whether the plan has a Favorable Letter,
- Whether the plan has both Operational, Plan Document, Demographic, and/or Employer Eligibility Failures, and
- Whether the Plan has Transferred Assets as a result of a merger or acquisition transaction. Refer to section 5.01(8) of Rev. Proc. 2002-47 for the definition of Transferred Assets. (See Employee Plans Determinations Quality Bulletin FY 2003 No. 2, dated February 26, 2003, for guidance on Processing Determination Letter Applications Involving Plan Mergers, Consolidations, Spin-offs, or Transfers of Plan Assets or Liabilities. This document is available on the IRS Intranet site.)

For 403(b) Plans only, consider whether:

- The plan has a combination of Demographic, Operational and Employer Eligibility Failures,
- The extent to which the errors relate to Excess Amounts, as that term is defined in section 5.02(3) of Rev. Proc. 2002-47, and
- The failure is solely an Employer Eligibility Failure.

Consultation with Area Coordinator and field manager

The specialist will discuss the sanction range with the Area Coordinator and his/her manager prior to contacting the Plan Sponsor and/or representative regarding the sanction amount. During the discussion with the Area Coordinator and his/her manager, the specialist will recommend a sanction amount and identify the factors that support his/her recommendation.

Negotiating the sanction amount with the Plan Sponsor

The specialist may set up an in-person meeting to conduct the negotiations for the sanction amount with the Plan Sponsor and/or representative(s), or this may be done through a phone conference. The specialist may include the group manager and the Area Coordinator in the conference or phone call.

Remember that only representatives who are enrolled actuaries, licensed attorneys, or Certified Public Accountants may negotiate the closing agreement sanction for their clients. Look at the Form 2848 and Circular 230 for more information.

Continued on next page

The Maximum Payment Amount and Sanction amount,

Continued

Statute of limitations

Remember to protect the statute of limitations for the plan year under audit. Discuss with your manager whether prior years should be placed on AIMS and whether Forms 872 should be solicited to extend the statute of limitations on years for which the statute is about to expire. Look at IRM section 4.71.9 for guidance on statutes.

If Maximum Payment Amount is more than \$ 1 million

If the MPA is in excess of \$1 million dollars, then the specialist and the Area Coordinator will consult with the Voluntary Compliance Manager to determine the appropriate sanction.

Who pays the sanction and other requirements

Usually the Plan Sponsor pays the sanction.

In the case of a plan with several adopting employers or a controlled group of companies, two or more Plan Sponsors may allocate the payment of the sanction among themselves.

It is also possible that the sanction will be paid by an entity other than the Plan Sponsor. The Plan Sponsor may be able to get a responsible party (e.g., a third party administrator) to reimburse or pay the sanction. There may be a malpractice suit and insurance to cover the sanction. The sanction may be covered by the terms of the fidelity bond. The Plan Sponsor may be able to get another party to pay the sanction.

In one case, where the Plan Sponsor was taken over by the Insurance Department of the state that it resided in, the individual who was acquiring the assets of the insurance company, in receivership, reimbursed the state for the sanction as one of the conditions of the purchase transaction.

The plan trustee or trustees may also pay the sanction.

Continued on next page

The Maximum Payment Amount and Sanction amount,

Continued

**Processing the
sanction
payment**

The sanction is paid to the United States Treasury at the same time that the closing agreement is signed. When sanction payment(s) are received from the Plan Sponsor or the authorized representative, the specialist must:

1. Verify that the payment equals the sanction amount specified in paragraph 1 of the closing agreement, and
2. Verify that the payment is in the form of a cashier's or certified check. Failure to secure a cashier's or certified check will cause processing delays for your case. Any personal or corporate checks must be mailed or hand-delivered back to the Plan Sponsor, and a cashier's or certified check must be secured in its place.

Remember, there must be a sanction payment for each closing agreement.

For each check secured, prepare Form 3244, Payment Posting Voucher, and Form 5734, Non-Master File Assessment Voucher. (You may download templates for these forms from the Intranet.) Leave the tax period blank on these Forms. When the check is processed, the Area Coordinator will write the date that the closing agreement is signed by the representative for the Service in this space.

Audit CAP for a Plan Document Failure or Other Related Issues

**Favorable
Letter defined**

For Qualified Plans, the term Favorable Letter means:

- A current favorable determination letter for an individually designed plan (including a volume submitter plan that is not identical to an approved volume submitter plan),
- A current favorable opinion letter for a Plan Sponsor that has adopted a master or prototype plan (standardized or nonstandardized), or
- A current favorable advisory letter and certification that the Plan Sponsor has adopted a plan that is identical to an approved volume submitter plan.

Refer to section 5.01(4) of Rev. Proc. 2002-47 for more precise definitions of the phrases “current favorable determination letter”, “current favorable opinion letter”, or “current favorable advisory letter”.

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Audit CAP for a Plan Document Failure or Other Related Issues, Continued

Plans must be amended for GUST

In the past several years, there have been new statutes that require all plans to be amended (“GUST” and “EGTRRA”). Rev. Proc. 2002-47, section 5.01(4), specifies which plan amendments had to be reviewed by the Service in order for the plan to have a Favorable Letter for purposes of EPCRS. The plan amendments will vary, depending on the type of plan. A plan that is terminated prior to the expiration of the remedial amendment period (RAP) under Code section 401(b) for GUST must be amended for the provisions required by GUST.

GUST refers to the passage of 4 recent statutes that require plan amendments:

- “G”--Uruguay Round Agreements Act (GATT),
- “U”--the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA),
- “S”--the Small Business and Job Protection Act of 1996 (SBJPA), and
- “T”--the Taxpayer Relief Act of 1997 (TRA '97), the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98), and the Community Renewal Tax Relief Act of 2000 (CRA 2000). (Note that the RAP for CRA 2000 has been extended by Rev. Proc. 2002-73 to the latest of the end of the first plan year beginning on or after January 1, 2002, the end of the plan’s GUST remedial amendment period, or June 30, 2003.)

See also Rev. Proc. 2002-73, which extends the GUST remedial amendment period to September 30, 2003 for certain Prototype and Volume Submitter Plans.

The Service is not yet ruling on the Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA). Under Notice 2001-42, a Plan Sponsor must amend its plan for EGTRRA at the end of the 2002 plan year or if later, by the end of the GUST remedial amendment period.

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Audit CAP for a Plan Document Failure or Other Related Issues, Continued

Nonamender failures

When a Plan Sponsor fails to amend its plan for a newly enacted qualification requirement within the remedial amendment period under Code section 401(b), this is commonly referred to as a “nonamender” failure. If a Plan Sponsor submits a determination letter application and voluntarily identifies a known nonamender failure (e.g., within the cover letter to such application) to the Service, the Plan Sponsor will be given the opportunity to perfect a submission under the Voluntary Correction Program. However, if a Plan Sponsor submits a determination letter application and does not identify a known nonamender failure to the Service, once the specialist finds the failure, the failure will be resolved through a closing agreement and the Audit CAP sanction structure applies.

Failure to reach agreement

A closing agreement is not valid until full correction is made, and both parties (the Plan Sponsor or the Service) execute the agreement. Either party may walk away from the negotiations.

If you cannot agree with the Plan Sponsor or authorized representative as to correction, the amount of the monetary sanction, or the Plan Sponsor’s and/or representative’s failure to submit requested information, you cannot simply close an Audit CAP case. You have to prepare it as an unagreed case.

For a Qualified Plan, if the Service and the Plan Sponsor cannot reach a satisfactory, mutual agreement with respect to the sanction amount and the correction of all failures (including methods of correction, timing of correction, and the list of affected participants), the plan will be disqualified and any previously issued determination letters will be revoked.

Continued on next page

Audit CAP for a Plan Document Failure or Other Related Issues, Continued

Failure to reach agreement
(continued)

In the case of a SEP or 403(b) Plan, if the Service and the Plan Sponsor cannot reach a satisfactory, mutual agreement with respect to the sanction amount and the correction of all failures, the Plan Sponsor will not have reliance on Rev. Proc. 2002-47.

You must consult with the Area Coordinator and your group manager prior to preparing to close the audit as an unagreed case. Also, the group manager and/or Area Coordinator may request involvement from the Area Manager on the more complex and technically difficult cases. Finally, the Plan Sponsor may request a conference with your manager or request to speak with the Area Coordinator in order to reach an agreement with regard to the sanction amount or correction.

Importance of documenting the workpapers

The primary purpose of proper documentation is to permit someone who is unfamiliar with the case to understand the facts, issues, government's argument, and Plan Sponsor's argument. Therefore, the following items should be documented:

- The terms (i.e., sanction amount, methods of correction, timing of correction, and list of affected participants) that were offered by the specialist to the Plan Sponsor,
- The Plan Sponsor's rejection of the terms,
- The manager's involvement with the closing agreement process, and
- Communication with the Area Coordinator regarding closing agreement terms and correction requirements.

This documentation can take many forms, such as:

- A Case Chronology Record, and
- Internal memoranda, routing slips, or other correspondence between the specialist, his/her group manager, and/or the Area Coordinator.

The actual format of the documentation is not our focus here – it's the data that's important.

Remember, proper documentation of your case file will enable Appeals to use the terms that you had previously offered to the Plan Sponsor as a baseline for their negotiations.

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Audit CAP for a Plan Document Failure or Other Related Issues, Continued

Prepare an unagreed case and ship the case to Mandatory Review

Prepare the case file for an unagreed revocation or disqualification closing. You will need to prepare the Revenue Agent's Report (RAR) and Administrative Record with your case file. Cite the appropriate Code, regulations, court cases, and other published guidance to support your case. For the law section of your Revenue Agent's Report, you may refer to the logic and holding in *Buzzetta Construction Company v. Commissioner* and *Martin Fireproofing v. Commissioner*, where the Tax Court affirmed the Service's discretion to retroactively disqualify plans.

You may also need to prepare discrepancy adjustments for related income tax issues.

After your manager has approved the unagreed closure, the case should be shipped to Mandatory Review in Baltimore, Maryland. Currently, Steve Moses is the manager of this group.

Mandatory Review's role

Mandatory Review personnel will review the unagreed case and perform a statute check. Then they will prepare the proposed revocation or disqualification letter, as appropriate, and mail it to the Plan Sponsor, with publications explaining the Plan Sponsor's appeals rights.

If the Plan Sponsor does not file a formal written protest and request a hearing with the Appeals Office, Mandatory Review will issue a final revocation or nonqualification letter. Note that Area Counsel approves these letters, prior to mailing.

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Audit CAP for a Plan Document Failure or Other Related Issues, Continued

**Procedures if
Plan Sponsor
files a protest**

If the Plan Sponsor files a protest, the case will be sent to Appeals and then forwarded to Area Counsel. The Plan Sponsor is entitled to appeal rights if the closing agreement is not secured at the field group level. At the Appeals level, the Appeals Officer may offer the Plan Sponsor a closing agreement or send the case back to the field specialist for further development and processing.

The Plan Sponsor may also file a petition with Tax Court to have the case heard.

(See chapter 12 from CPE 2002 regarding “Summary of Declaratory Judgment, the Administrative Record and Building a Case for Litigation” for more details of what to include in the unagreed case file. See also EP Exam Programs and Review-Quality Newsletter for December 2002, for an article on these procedures.)

Negotiating under Audit CAP

Prepare before negotiation

Before meeting with the Plan Sponsor, be prepared to discuss the issues.

There are several ways to prepare. Here are some examples:

- List the advantages and disadvantages of each proposed correction method. Make sure each proposed correction method resembles one in the Code, Rev. Proc. 2002-47, or other published guidance.
 - Discuss and brainstorm with your manager and the Area Coordinator for your best alternatives and walk-away position.
 - Explore creative and productive solutions to your complex issues.
 - Review the terms of the plan. Certain types of amendments may only be made on a prospective basis. If the Plan Sponsor needs to conform the terms of the plan to prior operations, make sure that the proposed amendment does not raise a Code section 411(d)(6) impermissible cutback issue.
 - Review your notes and workpapers.
 - Determine whether the Plan Sponsor will need to submit a determination letter application. If so, this would require a separate user fee.
-

Factors to consider when negotiating correction

Listen to and consider the other side's positions. Try to be flexible because sometimes a perfect solution on paper cannot be implemented due to conditions beyond your control.

Prioritize the issues and correction requirements. Consider:

- The de minimis amounts in Rev. Proc. 2002-47 for corrective contributions and distributions (\$50 and \$100 respectively),
 - Whether the Plan Sponsor is willing to include subsequent years for corrections, and
 - Consider whether the Plan Sponsor has made a good faith effort to locate and notify lost participants and their authorized beneficiaries. For example, did the Plan Sponsor use the IRS Letter Forwarding Program? If yes, then the Plan Sponsor may make correction for the employees that can be located and may agree to make correction for any lost participants or beneficiaries who contact the Plan Sponsor after correction is implemented.
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Negotiating under Audit CAP, Continued

Tips when negotiating with the Plan Sponsor

- Do not let the Plan Sponsor or the authorized representative intimidate you during your negotiations or follow-up meetings.
 - Do not lose control of the meeting(s). Beware of delaying and distracting tactics. Also, be wary of the good guy/bad guy routine that some taxpayers and representatives may use.
 - Do not let personality conflicts interfere with your best judgments.
 - Consider the facts and circumstances of the case. Determine why the errors occurred and negotiate for changes to the practices and procedures to ensure that the same deficiencies do not recur.
 - Maintain your professional demeanor and your sense of humor. A tense meeting may be counterproductive. If the meeting gets too intense, take a break and get a glass of water or some fresh air. Draw on your experience and common sense. Sometimes the answers will come to you after a good night's sleep or even a cup of coffee. If you hit the writer's block or stuck mode, take a break. In essence, do whatever you need to do to remain professional and creative as you negotiate with the Plan Sponsor or the representative.
-

Correction Principles

Introduction

EPCRS' correction principles are described in section 6 of Rev. Proc. 2002-47. Generally, a failure is not corrected unless full correction is made with respect to all participants (former and active) and authorized beneficiaries and all taxable years (whether or not the taxable year is closed under statute).

Correction under Audit CAP must be made prior to the execution of the closing agreement by the Plan Sponsor and the Service. If correction is made for a closed year, the tax liability for that year will not be recomputed as a result of the correction.

For a Qualified Plan with an Operational Failure, correction is determined by taking into account the terms of the plan at the time of the failure. Referring back to the plan terms is crucial when choosing an appropriate correction method.

Continued on next page

Correction Principles, Continued

**General
correction
principles**

- The correction method should restore the plan to the position it would have been had the failure not occurred.

Restore both current and former participants and beneficiaries the benefits and rights that they would have been entitled to had the failure not occurred.

- The correction method should be reasonable and appropriate for the failure.

For Qualified Plans, any correction method permitted under Appendices A or B of Rev. Proc. 2002-47 is deemed to be a reasonable and appropriate method of correcting the related Qualification Failure. For 403(b) Plans, any correction method permitted under Appendix A of Rev. Proc. 2002-47 is deemed to be a reasonable and appropriate method of correcting the related 403(b) Failure. Determining whether a correction method is reasonable and appropriate will depend on the specific facts and circumstances of each case and the principles described in the next section.

- The correction method should resemble one already provided for in the Code, the regulations thereunder, or other authoritative guidance.
- The correction method for failures relating to nondiscrimination should provide for benefits for nonhighly compensated employees.
- The correction method should keep plan assets in the trust, except to the extent provided for in the Code, the regulations or other authoritative guidance of general applicability provide for correction by distribution to participants or beneficiaries or return of assets to the Plan Sponsor.

Continued on next page

Correction Principles, Continued

**General
correction
principles
(continued)**

- The correction method should not violate another provision of Code section 401(a) (for Qualified Plans), 408(k) (for SEPs), or 403(b) (for 403(b) Plans).

Example: Employee deferrals exceeded Code section 403(b) limits. As a result of this failure, the excess deferrals (adjusted for earnings) should have been distributed to the participants and included in the participants' income in the year that the distributions were made. As part of the corrective distribution, the Plan Sponsor must inform the participants that their distributions are not eligible for favorable rollover treatment.

- The correction method should be applied consistently in correcting all Operational Failures of the same type in the same Plan Year. Earnings (or loss) adjustment methods should also be applied consistently to all corrective contributions or allocations for a particular type of failure for a Plan Year.

Specific Correction Methods

Corrective Allocations for DC Plans

Example: An allocation under a profit sharing plan (with or without a Cash or Deferred Arrangement feature) or money purchase pension plan should be based upon the terms of the plan (including the compensation that would have been used under the plan for the period with respect to which a corrective allocation is being made) and other applicable information at the time of the failure.

The allocations should be adjusted for earnings or losses and forfeitures that would have been allocated to the participant's account had the failure not occurred. See section 3 of Appendix B to Rev. Proc. 2002-47 for information regarding the computation of earnings and losses on corrective allocations.

Corrective allocations and Code section 415

A corrective allocation to a participant's account related to a prior limitation year will be considered an annual addition in the limitation year to which the allocation relates. Thus, the corrective allocation will not be considered an annual addition when the actual correction is made.

For example, a participant did not receive an allocation for the 1998 plan year. (The plan year and the limitation year are the same.) The Plan Sponsor corrects this failure in 2002 by contributing \$5,000 to the participant's account. The \$5,000 contribution is considered an annual addition for 1998 and not for 2002.

Corrections and Code section 404

The normal rules of Code section 404 apply for deductibility on the Plan Sponsor's income tax return. The amount must not exceed deduction limits and must be paid by the due date of the Plan Sponsor's income tax return plus valid extensions, if any.

Corrective Distributions—which forms to file

Corrective distributions must include an adjustment for lost earnings. The Plan Sponsor must prepare and file the appropriate tax forms, participant account statements, and participant notices to document the distribution. The Plan Sponsor must file Form 1099-R along with Form 1096 to report the distribution to the participant(s) and the Service. The Plan Sponsor also files Form 945 to report the federal income tax withheld from the corrective distribution(s). If you notify the Plan Sponsor of the filing requirements for the distributions, then you do not need to hold the case open until all appropriate forms are filed.

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Specific Correction Methods, Continued

Corrective distributions—employee notices, spousal consent

The Plan Sponsor must issue a corrected participant statement to show the corrected account balances. The Plan Sponsor must also distribute the notices that ask for the participants' permission for distributions in excess of either \$3,000 or \$5,000 (depending on the plan terms and when the plan was amended).

There is a statutory 60-day waiting period associated with the rollover requirement. (See Rev. Proc. 2003-7 for how a taxpayer may apply for a waiver of the 60-day period.)

If the plan is a pension plan and is subject to Code section 417, the spousal consent notices must also be sent, and spousal consent for the distribution(s) must be obtained. (If the spouse does not consent, then the spouse may be entitled to an annuity, and the Plan Sponsor will have to make additional payments to the trust to cover this requirement.)

If a distribution is eligible for rollover treatment, the Plan Sponsor must issue the notice to the participant asking for the election of lump sum distribution or rollover treatment. If the distribution is made in a lump sum, the distribution is subject to federal income tax withholding at a 20% rate.

Since some types of corrective distributions are not eligible for rollover treatment, the Plan Sponsor must issue notices to the participants informing them that the distributions are subject to 20% federal income tax withholding and are not eligible for favorable rollover treatment.

Corrective distributions for plans that have terminated

Sometimes the Plan Sponsor will have already terminated the plan and distributed assets prior to your audit or determination letter review. In this case, the Plan Sponsor must re-establish the plan trust account.

To protect the participants' rights to rollover treatment of the trust distribution, the Plan Sponsor must then deposit the required corrective contributions in the trust account. The Plan Sponsor can then make corrective distributions to the affected current and former participants.

A subsequent trustee of a Qualified Plan or Individual Retirement Account (IRA) will not consider a check from the Plan Sponsor as being eligible for rollover. The check must be from the former Qualified Plan's trust account.

Workpaper Documentation

**Properly
documenting
workpapers—
in general**

Your workpapers for either an examination or determination case should be properly documented with sufficient evidence to support your conclusions. In addition, the workpapers should document how you reached your conclusions, based on the specific facts and circumstances of the case. If the workpapers are properly documented, your manager and, if applicable, Review should be able to completely understand:

- The issues that were raised on audit,
- The steps or analysis that you used to determine the extent of the failure, and
- The methods or analysis that you used to arrive at the correction methodology.

Although SCP and Audit CAP cases are not automatically mandatory review cases, the group manager may select the case for mandatory review, or there may be another issue in the case that may require sending the case to Mandatory Review. Currently, all cash balance conversion cases are Mandatory Review cases.

The workpapers should show how you exercised good judgment and reached reasonable conclusions.

Continued on next page

Workpaper Documentation, Continued

**Documenting
audit
procedures**

- The workpaper should contain a brief synopsis of the records inspected, original source documents reviewed, and the steps taken to verify the Plan Sponsor's calculations, testing results etc.

List each examination step that was performed, and if a schedule was done, reference the schedule relating to the audit step. You could list the source documents that were reviewed.

- Document how you determined which issue(s) were material and significant.

Example: The workpapers should specify the steps you took in testing compensation for compliance with the Code section 401(a)(17) limit.

Example: With respect to identifying HCEs for the ADP/ACP test or key employees for top heavy, your workpapers should show how you analyzed the Plan Sponsor's method for determining the HCEs or key employees and a conclusion of whether the Plan Sponsor correctly determined such employees.

Example: Note whether the Plan Sponsor is using current year or prior year for the nondiscrimination testing and whether the Plan Sponsor adopted the amendment that chooses which method to use on a timely basis.

Continued on next page

Workpaper Documentation, Continued

**Documenting
audit
procedures
(continued)**

- Document how discrepancies and deficiencies were resolved.
- Leave an audit trail so someone can follow your logic.

For example, when pre-planning and reviewing the Form 5500 balance sheet, you identify participant loans that may be prohibited transactions. You should show how you resolved this issue in your workpapers.

- Do not purge correspondence with the Plan Sponsor that shows an exchange of information and/or contains data supporting your analysis of a particular issue.
- Information about your audit pre-plan, field visits, phone contacts, audit procedures, correspondence, and conclusions should be provided to support your decision to process the case as a no-change examination, Self-Correction Procedure, or Audit CAP case.
- Include the initial audit letter in the correspondence section of the workpapers.
- Include each Information Document Request with the Plan Sponsor's response in the correspondence section of the workpapers.

**Computation or
information
schedule**

The workpaper may contain a computation or workpaper schedule that references source data.

- An information schedule may be used to summarize Plan Sponsor information.
 - A computation may also be used to verify the Plan Sponsor's calculations.
 - A schedule may identify a sample of a Plan Sponsor's workforce.
-

Potential source of errors--items to review when auditing a plan

Reviewing administrative practices and procedures is crucial to an audit

Reviewing the Plan Sponsor's or third party administrator's internal controls, i.e. administrative practices, would reveal the audit areas that are most at risk.

Analyzing and properly judging audit risk is critical in determining how much reliance you can place on the administrative practices and procedures.

Determining your level of reliance on a Plan Sponsor's administrative practices and procedures will determine the extent of your audit substantive tests and other audit procedures. The manner in which you resolve your case (e.g., through Audit CAP or through Self-Correction Program) may require a change to the Plan Sponsor's practices and procedures.

Reviewing the corporate organization chart

Sometimes just reviewing the corporate organization chart will aid you in identifying a potential issue. Keep in mind that a company may acquire or dispose of a subsidiary during the year. This might affect participation testing under Code section 410(b). This process may also help you to identify a separate line of business issue.

Review changes in the plan's record keeper

What sometimes happens is the Plan Sponsor will change personnel in charge of administering the plan or change the third party administrators, and the new administrator will do a thorough review prior to accepting the new client. Errors and omissions may be identified during this process that require resolution. Sometimes the Plan Sponsor will volunteer this information, and sometimes the specialist will identify the issue. Verify that correction was completed prior to the audit, or you will need to secure correction. (See the section on correction above.)

Other changes to Plan Sponsor could reveal errors

Possible failures could stem from the acquisition of another company.

Verify that hire, rehire, and participation dates have been properly recorded to determine possible Operational Failures.

Failures could also arise due to the implementation of new plan accounting software.

Sampling

Document whenever you use a sampling technique as part of your audit procedures.

For example, on a CEP or large case audit, you may consult with a Computer Audit Specialist (CAS) to obtain a database from which your audit sample of participants (to test dates of hire, dates or participation, or dates or termination) was drawn.

Document whether:

- You used scientific or random sampling techniques.
 - You tested 100% of the database or a selection of participants or data fields.
 - How you selected participants or data fields.
-

Where to Conduct the Audit

The fieldwork section of the examination should take place at either the Plan Sponsor's or representative's place of business. The location should be where the books and records are located.

The opening conference, the fieldwork, and the closing conference take place in the field. Follow-up visit(s) may be needed to resolve open issues.

Sometimes, your manager will accompany you to one or more of these meetings to help resolve issues or to perform a field visit.

Continued on next page

Potential source of errors--items to review when auditing a plan, Continued

**Tips About
Required
Closing
Procedures**

The case chronology should reflect discussions with either your group manager or the Area Coordinator. The workpapers should reflect the level of supervision or guidance that the manager and Area Coordinator gave you during the audit.

Any consultations with experts such as an IRS actuary or Review personnel should also be reflected in the case chronology.

You will need to complete the CECA checksheet or the 401(k) worksheet for 401(k) pilot project cases. Please complete these items accurately and completely. (See the EP Exam Programs and Review-Quality Newsletter for December 2002 for an article for further guidance on CECA disk procedures.)

Note that many of these suggestions are part of the TEQMS standards and the Internal Revenue Manual EP examinations section. You may want to review those documents to assist you with your audit planning and implementation.

**Closing Letter
Tips—when
cases can be
closed**

The case file for an examination Audit CAP case may not be closed until the specialist receives the executed closing agreement back from the Area Coordinator.

The case file for an examination SCP case may not be closed until the specialist secures the group manager's signature (and the Area Coordinator's signature if the issue is significant and not corrected by one of the methods in Appendix A or B to Rev. Proc. 2002-47).

For determination Audit CAP cases, the determination letter will not be issued to the Plan Sponsor until the closing agreement is signed by the Plan Sponsor and the representative for the Service. It is usually a good idea to include the determination letter in the envelope that is being used to mail one of the signed closing agreements to the Plan Sponsor.

Continued on next page

Potential source of errors--items to review when auditing a plan, Continued

Importance of closing codes

Be certain to include the proper closing code on your closing document.

Please use:

- Code 14 for Self-Correction Procedure cases.
- Code 15 for Audit CAP cases.

Please do not close an examination case as a “no change” or Code 02 after securing corrections from the Plan Sponsor. The closing codes are an important tool for management to capture and evaluate the results of your audit efforts. Management determines the best allocation of examination resources by using closing codes. Finally, the closing codes are used to determine whether additional resources should be allocated for EP examination.

Also, please make sure that you pick the proper issue code to complete the closing document.

Example: If you were able to get the Plan Sponsor to restore account balances for improperly excluded participants in a money purchase pension plan; you should be using code 03.

Example: If you picked up a Form 5330 for failure to meet minimum funding standards under Code section 4971, you should be using code 01.

A Note about the Self-Assessment

You might also want to keep track of your case failures and resolutions of these failures for your annual self-assessment. Properly resolved issues for either Self-Correction Program cases or Audit CAP cases are good illustrations of your ability:

- To identify and develop tax issues, and
 - To apply the tax law and applicable guidance.
-

Common Misconceptions about Audit CAP and How to Avoid Them

Process is too time consuming

Although the unique and more complex technical issues do require substantial research and patience to resolve, it is important to remember that the majority of this research is required to properly develop your issue(s), regardless of whether any failure(s) are resolved through Audit CAP.

We have implemented the following time-saving tools:

- Procedural checklists to help you determine appropriate correction methods and sanction amounts,
- Sample letters to facilitate information requests and/or explain the Audit CAP process to Plan Sponsors, and
- Sample closing agreements for common failures.

Overall, Audit CAP is much faster and easier than most people would suspect.

Sanctions are too expensive

While it is true that sanctions under Audit CAP are frequently higher than Plan Sponsors and/or their authorized representatives would like, even they would admit that the sanctions are less than what they would have to pay if the Service pursued plan disqualification.

Furthermore, to encourage voluntary compliance, the sanction has to be higher than the fee amount that the Plan Sponsor would have paid if it had resolved the failure(s) under the Voluntary Compliance Program (VCP). After all, no one is going to pursue voluntary compliance if they know that they'll get a better deal (i.e., pay less) if the Service discovers the plan's failures upon audit.

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Potential source of errors--items to review when auditing a plan, Continued

The cost to correct is too high

As with sanction amounts, Plan Sponsors and the Service frequently disagree as to which correction method best fits a given situation. All too often, Plan Sponsors are more concerned about the cost associated with a particular correction method than with the objectives that are achieved by that correction method. As a result, we must seek out correction methods that not only protect the participants' benefits and rights under the plan document but also are reasonable in cost and nature. We don't want to compromise participants' benefits for the sake of saving the Plan Sponsor a little money, but on the other hand, we don't want to force a Plan Sponsor into bankruptcy by pursuing an exorbitantly costly correction method when an alternative would achieve the same basic objectives.

You may brainstorm with your manager and the Area Coordinator to find a mutually acceptable correction method to resolve each failure.

Any issue can be resolved under Audit CAP

This statement is false. While EPCRS is available to resolve the majority of Qualification Failures, there are a few issues that cannot be resolved under EPCRS. Since Audit CAP is a component of EPCRS, these exceptions naturally apply to Audit CAP as well.

Issues that cannot be resolved under EPCRS:

- Diversion or misuse of assets
 - Excise tax liabilities
 - Income tax liabilities that are not directly related to plan disqualification
 - Additions to tax (e.g., Code section 72(t))
 - Employment tax liabilities
-

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Potential source of errors--items to review when auditing a plan, Continued

Negotiating the sanction is too difficult

Negotiating a sanction does not have to be difficult. Remember that the MPA does not have to be an exact figure but is simply the beginning amount for your negotiating position. A ballpark estimate may be sufficient.

Here are some things to keep in mind when estimating the MPA:

- Ask the Plan Sponsor or authorized representative to estimate the MPA. If the Plan Sponsor cannot do so, then you may estimate it using the documents available.
 - You may factor in the Plan Sponsor's attempt to correct and the degree to which the Plan Sponsor completed correction prior to the commencement of the audit.
 - Consider whether the Plan Sponsor volunteered to correct Operational Failures, not yet identified upon audit, for subsequent plan years.
 - Consider whether the Plan Sponsor has other plans that would possibly be subject to the same Operational Failures.
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Elements of a closing agreement

Introduction	Another misconception is that a closing agreement is difficult to draft. This section explains each part of the closing agreement with the goal of easing the burden of drafting a closing agreement.
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Identification section	This must contain the full legal name, address, and Taxpayer Identification Number (TIN) of each party (e.g., the Plan Sponsor, the Plan and Trust, the Owner, etc.). NOTE: Do not list an address and TIN for the Service.
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Facts	<p>This section specifies:</p> <ul style="list-style-type: none">A. Who established the plan and also specifies the effective date of the original plan document.B. Identifies the fiscal year end of all parties (except the Service).C. Provides a complete description of the plan's qualification history (including the dates on which determination letters were issued and/or significant amendments were adopted).D. Concludes with a description of the failure(s) identified during the examination of the plan or determination letter application process.
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This section of the closing agreement is generally the same as the first section of the Revenue Agent's Report.

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Elements of a closing agreement, Continued

Facts (continued)

Some tips and common items:

- Provide a clear picture to the reader as to what happened.
- Determine and state the parties to the closing agreement.
- Indicate whether this case resulted from an audit or the review of a determination letter application.
- Determine and state whether the Plan Sponsor identified and voluntarily corrected the failure(s) or whether the specialist identified, developed, and required correction for the Qualification Failure(s).
- State how each failure was resolved. You may review your workpapers, Information Document Requests, and correspondence to refresh your memory of how each failure was resolved.

NOTE: If you are resolving **more than one failure** within the closing agreement, instead of listing everything in chronological order, assign a name to each failure (e.g., "Failure #1", "Failure #2", etc.) in the very first part of this section and then use these names throughout the remainder of the closing agreement. Refer to Exhibit 4 for a sample closing agreement that demonstrates this format.

Conclusion section

This section explains the conclusions that the Service would have drawn if the Plan Sponsor had refused to correct the identified failure(s) in accordance with the Service's instructions.

NOTE: If you are resolving **more than one failure** within the closing agreement, the effective date of the revocation of qualified status will generally be the first day of the earliest plan year in which an identified failure occurred. Refer to Exhibit 4 for a sample closing agreement that demonstrates this format.

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Elements of a closing agreement, Continued

**Correction
section**

This section explains how each failure was corrected, including specification of the amount of any additional employer contributions, distributions from the plan, etc. Note: For disclosure reasons, do not refer to affected participants by name. Instead, refer to the participants in general terms. For example, two participants had corrective contributions made to their accounts.

Remember that the correction method must resemble one in the Code, the Regulations, and/or the other published guidance. State how the Plan Sponsor has changed its practices and procedures (internal control) so that the problem will not reoccur.

NOTE: If you are resolving **more than one failure** within the closing agreement, describe the corrective action taken for each failure separately (e.g., in separate subparagraphs). Refer to Exhibit 4 for a sample closing agreement that demonstrates this format.

**Certification
section**

This section describes the certifications, if any, made by the Plan Sponsor.

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Elements of a closing agreement, Continued

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- Terms section** This section defines the terms agreed to by all parties. Specifically, these are the numbered paragraphs and usually consist of:
- a.) The amount of the sanction to be paid by the Plan Sponsor (or another party to the closing agreement). This is always designated as paragraph #1.
 - b.) The Service's agreement to treat the plan as if the identified failures had not occurred. This is always designated as paragraph #2.
NOTE: If you are resolving **more than one failure** within the closing agreement, describe the agreement terms for each failure separately (e.g., in separate subparagraphs under paragraph #2). Refer to Exhibit 4 for a sample closing agreement that demonstrates this format.
 - c.) The Plan Sponsor's and the Trust's agreement not to deduct the sanction. This is always designated as paragraph #3.
 - d.) The Plan Sponsor's agreement that the sanction cannot be considered as any form of compensation or income to any employees or former employees of the Plan Sponsor. This is always designated as paragraph #4.
 - e.) The statement that the closing agreement only rules on the failure(s) described within the closing agreement, etc. This is always designated as paragraph #5.
 - f.) The statement regarding the finality of the closing agreement, etc. This is always designated as paragraph #6.

Exhibit 3 below is a sample closing agreement that contains the exact language required for items (c) through (f) above. Also, see #5 of General Comments and Tips below.

Continued on next page

Elements of a closing agreement, Continued

Signature line section

This includes a signature line for each party (including the Service). NOTE: There must be at least **two** signature lines on the last page of the closing agreement.

Prepare a signature section on the last page of the closing agreement. A separate line is required for the signature for each party to the closing agreement. The Plan Sponsor usually signs for the plan. If the plan is a multiemployer plan, the plan trustees typically sign the closing agreement. The Area Manager typically signs for the Service.

General comments and tips

1.) **Header #1** – appears at the top of page 1 only. It reads “CLOSING AGREEMENT ON FINAL DETERMINATION COVERING SPECIFIC MATTERS”, is in bold print, and is underlined.

2.) **Header #2** – appears at the top of page 2 and all subsequent pages. It should specify the full legal names of all parties to the closing agreement except for the Service on a separate line within Header #2. It should be in bold print.

3.) **Footer** - appears at the bottom of each page. It reads "Audit CAP - Page X of X" and is in bold print.

4.) **Code citations** - For sections 2 (Facts), 3 (Conclusion), and 6 (Terms), the description of all Qualification Failures should include a reference to Code section 401(a). In other words, for a violation of Code section 410, 411, 415, 416, 417, etc., you must also include the corresponding cite under Code section 401(a).

5.) **Preformatted language** - If preformatted language has been provided to describe certain routine items or transactions within any section of the closing agreement, that language should be used. It should not be rewritten/revised unless truly necessary, and all revisions must be approved by the Area Coordinator. This is especially important for section 6 (Terms) of the closing agreement.

6. **Two or more plans for one Plan Sponsor** - If you have two or more plans for one Plan Sponsor, prepare a separate closing agreement for each plan. Each plan’s closing agreement will require a separate check, posting voucher, and memo to the Service Center.

Exhibit 1**Exhibit 1:****(Note: Type or print this on IRS Letterhead)****Memo to the
CSPC to
Transmit the
Check and
Closing
Agreement**

MEMORANDUM FOR: Cincinnati Submission Processing Center

ATTN: Phyllis Shields, Deposit Unit, Stop 31
201 W. Rivercenter Blvd.
Covington, KY 41011

DATE:

FROM: _____
Area Coordinator
TE/GE Division, Employee PlansSUBJECT: EP Closing Agreement under the Audit Closing
Agreement ProgramAttached is a closing agreement executed on _____, as
noted:

Payer's Name:

Payer's EIN:

Payer's Address:

Applicable Plan Name: Plan #001

The closing agreement should be routed to the accounting branch for assessment and credit. The assessment should be made as a Non-Master File assessment, true tax class 6, and abstract number 139. (Please refer to IRM 3(17)(243)5.2 for processing instructions.)

There are to be no refunds of moneys under this closing agreement.

If you have any questions, please contact me at (xxx) xxx-xxxx. Thank you.

Attachment - closing agreement and remittance

**Exhibit 2:
Document
transmittal**

To (Show complete and correct address)

Internal Revenue Service
Attn: Phyllis Shields, Deposit Unit, Stop 31
201 W. Rivercenter Blvd.
Covington, KY 41011

Release date

Page **1** of **1**

Transmittal code (From-Serial no.- to)

Numbered

EP

Unnumbered

Document Identification

Remarks

Shipment Information

Quantity

Code
or
Type

Instructions: When transmitting reports
 please show the type of report and the
 period covered. For other items, show
 identifying information such as blocks,
 DLN, EIN, SSN, etc.

**Audit Closing Agreement Program –
 monetary sanction deposited through
 Cincinnati Submission Processing
 Center, ALC # 17**

Con-
tainer
No.Rec'd
(√)

1

Cover memorandum – Director, Cincinnati Submission Processing Center

1

Closing agreement

1

Form
3244-A

Payment Posting Voucher

1

Form
5734

Non-Master File Assessment Voucher

REMITTANCE:

NameEINCheck #AmountPlan #

From (Originator must supply complete address below)

Internal Revenue Service – TE/GE Division

Attention:

Releasing official (Signature and title)

Area Coordinator

Received and Verified (Signature and title)

Originator telephone number

Date Acknowledged

Form **3210** (Rev. 7-90)
 Catalog Number 22150T

Department of the Treasury
Internal Revenue Service

Part 1 - Recipient's Copy / Part 2 – For 3210 Book / Part 3 - Acknowledgement Copy / Part 4 – To Be Retained by Originator

Exhibit 3: Get to Know Your Area Coordinator

Name	Phone and Fax	Location-IRS Office Address	Area
Beth Levine	954-423-7466 954-423-7477 fax	SW 6 th Court, Room 306 Plantation, FL 33324	Gulf Coast EP 7646
Stanley Pustulka	716-961-5322 716-961-5375 fax	111 West Huron St., Room 1434 Buffalo, NY 14201	Northeast EP 7601
George Brim	215-656-7700, ext. 537 215-861-1038 fax	1601 Market Street Philadelphia, PA 19103	Mid-Atlantic
Carron Newby	312-566-3826 312-566-3915 fax	230 South Dearborn Street Chicago, IL 60604 (17 th Floor)	Great Lakes
Theresa Parsons	636-940-6309 636-940-6227 fax	1122 Town & Country Commons Chesterfield, MO 63017-8293	Central Mountain EP
Kevin Masushige	7661		
Frederick Parker	626-312-2933 626-312-2928 fax	Att'n.: TE/GE Division, 2 nd Floor 9350 Flair Drive El Monte, CA 91731-2885	Pacific Coast
	513-263-3410 513-263-3413 fax	550 Main Street Cincinnati, OH 45201	EP Determinations

Exhibit 4: Example of an Operational Failure - Failure to follow plan's terms**Case illustration**

A Plan Sponsor changed the third party administrator for the plan in a year prior to the year under audit and on AIMS. During this time, the Plan Sponsor amended and restated the plan document. The Plan Sponsor applied for and received a GUST II favorable determination letter. The plan had a previous favorable determination letter dated 2/28/1995.

The Plan Sponsor inadvertently checked the box on the restated adoption agreement that read, "No hardship distributions permitted." Upon audit, the specialist discovers that two Non-Highly Compensated Employees (NHCEs) applied for and received hardship distributions in the year under audit. No Highly Compensated Employees (HCEs) received hardship distributions. In the year subsequent to the year under audit, three more NHCEs applied for and received hardship distributions. (Note: The violation does not discriminate in favor of HCEs).

It appears that there were no administrative policies and practices in place to ensure that the plan administrator or Plan Sponsor did not grant hardship distributions. (Note: The specialist will require the Plan Sponsor to adopt practices and procedures to ensure that hardship distributions are properly administered in the future.)

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Exhibit 4: Example of an Operational Failure - Failure to follow plan's terms, Continued

**Case
illustration
(continued)**

The Summary Plan Description (SPD) indicated that the plan would allow hardship distributions. When the specialist inquired about the possible failures, the Plan Sponsor's authorized representative indicated that the SPD permitted hardship distributions. The specialist reviewed the SPD. The effective date of the SPD, however, indicates that the SPD was not yet updated for the plan restatement under GUST II. It had been prepared for the initial plan adoption effective in January 1, 1992.

The specialist reviewed Rev. Proc. 2002-47. Failures involving hardship distribution violations may be corrected by retroactive amendments (as long as such amendments comply with the rules specified in section 4.06(2) of Rev. Proc. 2002-47 and section 2.07 of Appendix B to Rev. Proc. 2002-47). The specialist then knew that this case could be closed through SCP.

The specialist prepared the SCP worksheet and the group manager approved it. The specialist used Code 14, "SCP", on the closing document. The specialist prepared an individually designed closing letter to send to the Plan Sponsor and authorized representative. The letter described both the failure and its correction in great detail.

Note: If the facts of this case were changed so that participant loans had been distributed instead of hardship distributions, then the case would no longer be eligible for correction via retroactive plan amendment under SCP. If the plan sponsor wants to correct the loan error through a retroactive amendment, then the Plan Sponsor would have to resolve this Operational Failure under Audit CAP. However, if the failure is corrected by having the affected participants repay the loans to the plan, the plan would be eligible for correction under SCP.

The case would be closed using code 15, "Closing agreement", on the closing document. The specialist would have to secure approval from the group manager and the Area Coordinator prior to soliciting the signed closing agreements and sanction payment from the Plan Sponsor. The specialist would send Letter 1204 to the Plan Sponsor to close the case.

Exhibit 5: VCP request vs. audit of plan**Case study**

What happens if you discover several potential Operational Failures during your initial audit interview? You leave an Information Document Request asking for an explanation of the potential failures. The Plan Sponsor and the authorized representative respond to your inquiry by submitting a Voluntary Correction Program (VCP) request to you. Since the request was not submitted to the appropriate address (specified in section 11.12 of Rev. Proc. 2002-47) and was not submitted prior to the commencement of the audit, it is not a valid VCP request. The Plan Sponsor's submission of the untimely VCP request will not prevent you from completing the audit.

However, if the VCP request had been submitted to the Service at the appropriate address before the commencement of the audit, your audit would have been placed in suspense until processing of the VCP request had been completed and the compliance statement had been issued. In this situation, you should determine whether the failures identified in the VCP request occurred/existed during the year under audit. If you're conducting a limited scope audit (i.e., limited to only certain issues), you should determine whether the failures identified in the VCP request match those that you would be examining.
